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COMMENTS ON VALUE ADDED TAX CHARACTERISTICS. IMPLICATIONS FOR TAX MIX DESIGN IN UKRAINIAN TAX SYSTEM REFORM

- FIRST PRINCIPLES

In general, the role of the tax system is to allow the government to fulfil its obligations by generating necessary revenues as efficient, equitably and manageably as possible. This implies that taxation should minimize disincentives to work, invest and save. These are the broad guidelines as to a set of “first principles” for tax system.

- WORLDWIDE TRENDS

The issue of overall tax mix is perhaps the most fundamental problem in the design of tax system. Most general equilibrium models imply that **consumption taxation is less distortionary than income taxation** (because it does not distort decisions on savings and investment). This rule is reflected in practice, as there has been considerable convergence in tax mixes in the OECD countries. **Recent tax reforms in OECD countries resulted in** increase in social security taxation, a decrease in statutory and average effective rates of personal and corporate taxation, and **a shift toward indirect taxation (value added taxation of consumption)**. Most of OECD countries accepted the VAT as their main consumption tax. Only Switzerland, the United States and Australia are exemptions. Central and East European (CEE) countries follow this trends. Also developments in European Community are relevant to a discussion of the VAT in CEE countries.

- ADVANTAGES OF VAT

In general, economic literature provides several arguments in favor of VAT:

- **VAT does not distort domestic production and distribution** (neutral regarding the production technique as makes no difference for the tax liability whether a

- product is manufactured with capital- or labor-intensive technology; makes no difference how often a product is traded before it reaches the consumer)
 - allows for **undistorted optimal allocation of resources**
 - **neutral with respect to foreign trade** (exports are free of tax while imports can be taxed on exactly the same rules as domestically produced commodities)
 - as a simple transactions-based tax, VAT is **a certain levy and relatively easy to understand**
 - opportunities for **tax avoidance and tax evasion are more limited than under the income taxes**
- PROPERLY DESIGNED VAT

The requirements for a properly designed and operated VAT are the following:

1. VAT should be revenue productive and responsive to changes in revenue needs as well as simple and easy to understand
 - **broad tax base** covering as many goods and services as possible
 - the value of tax should be **base on the actual selling price**
 - **exemptions** of goods and services should be **limited** to those essential for social reasons or those involving administrative complexity
 - the **rate of tax** should be **uniform** or as little differentiated as possible
2. Destination principle should be applied (commodities should be taxed in the country where they are consumed).
3. Tax on the imported goods should be the same as the tax on domestically produced goods; exports should leave the country completely free of tax.
4. Cost of collecting and enforcing the VAT should be kept low.
5. VAT should be easy to comply with and should interfere as little as possible with the free functioning of business and trade.

- CONCLUSIONS AND RECOMMENDATIONS

As the reform of Ukrainian tax system is concerned there is a **strong advocacy for a considerable move from income taxation to general consumption taxes (VAT)**. Attaching much greater than currently importance to indirect taxation should take place, which may have some substantial positive features:

- **VAT tends to be less progressive than income taxes**. However, it may distort consumption patterns if rates are not uniform or there are numerous goods and services exempted.
- **VAT represents exceptionally stable source of government revenue** (since consumption as a share of GDP fluctuates little, by implication VAT is a fairly stable budget revenue source).
- **VAT is a flexible tax instrument** (VAT is collected on current basis thus a change in the rate translates immediately into more or less revenue).
- **VAT reduces tax disincentives** on decisions regarding savings and investment.
- **VAT may be treated as pro-investment measure** (thus pro-growth). Taxpayer having increasing disposable income (as the result of increasing incomes or

declining burden of direct taxation) is more eager to invest than to consume, as the consumption decisions are related to higher indirect taxation costs.

- **VAT is generally more effective in shadow economy taxation.** It is less easy to avoid for the underground or informal economy than direct taxation.
- **VAT is easier and cheaper in administration** and collection comparing to direct taxes.

In sum, in the absence of a workable income tax and increasing expenditure necessities, government's financing requirements can best be met by reliance, to a much larger extent, on a product-neutral, factor-neutral, revenue-productive/generating, administratively easy and feasible indirect tax, such as a VAT. While income tax can be employed to achieve distributional objectives, the focus of the VAT should be on revenue. **Having in mind the weaknesses of current structure of Ukrainian tax system¹ and above mentioned advantages of the VAT it is strongly recommended to retain the VAT rate on the current level of 20%** (uniform, not diversified tax rate). Unfortunately, tax reform proposed by the government foresees very fast, gradual reduction of VAT rate to the level of 19% and than to 17%. Moreover, combined tax rate is to be introduced, with 2% going for the purposes of innovation fund.

¹ The current tax system is characterized by decreasing productivity of indirect taxation. Indirect taxes revenues are considerably surpassed by performance of direct taxation.